

**Improvements Are Needed in the Automated
Underreporter Program to Ensure That
Taxpayer Information Sent to External Tax
Agencies Is Accurate**

September 2002

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This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

September 18, 2002

MEMORANDUM FOR COMMISSIONER ROSSOTTI

A handwritten signature in black ink, reading "Pamela J. Gardiner".

FROM: Pamela J. Gardiner
Acting Inspector General

SUBJECT: Final Audit Report - Improvements Are Needed in the Automated Underreporter Program to Ensure That Taxpayer Information Sent to External Tax Agencies Is Accurate (Audit # 200110043)

This report presents the results of our review of the Internal Revenue Service's (IRS) Automated Underreporter (AUR) program exchanging information with external tax agencies. The overall objectives of this audit were to determine if the IRS is protecting taxpayer rights and providing accurate information when disclosing AUR case information to external tax agencies.

In summary, the IRS matches information reported on individual tax returns against information reported by banks, employers, and other payers. In instances where the matching process identifies discrepancies, the taxpayer may have an additional tax amount due. Information about these additional tax assessments is exchanged with external tax agencies through the AUR program. Based on our statistical sample case review, we estimate 469 of 533 partially agreed cases sent to external tax agencies in the first 2 shipments of Tax Year 1999 contained inaccurate AUR case information. We also found that information disseminated to external tax agencies was inaccurate regarding the tolerance¹ criteria. In addition, the IRS did not change tolerances requested by 4 of 43 external tax agencies participating in the AUR program so that inaccurate information based on unchanged tolerances was disseminated to external tax agencies. These conditions could increase taxpayer burden and reduce the effectiveness of tax administration at the external tax agencies.

¹ Tolerances are the dollar amount criteria established by external tax agencies, for requesting taxpayer cases. The tolerances are used to exclude lower dollar AUR cases and information from being provided to external tax agencies.

We recommended the IRS stop shipping certain AUR information to external tax agencies until programming and procedural changes are made to prevent the shipment of inaccurate information, and the IRS should inform external tax agencies of this situation. We also recommended that information disseminated by the IRS to external tax agencies about tolerance criteria be clarified, including an outreach effort to clarify the application of the tax tolerance criteria. In addition, we recommended that changes to tax tolerance criteria be updated by the IRS when requested by external tax agencies.

Management's Response: The IRS management agreed with our results and recommendations. The IRS plans to stop sending potentially incorrect AUR information to external tax agencies until computer programming changes are made and will inform the external tax agencies of the inaccurate AUR information. The IRS has disseminated information to external tax agencies to clarify the tolerance criteria and has established procedures and responsibilities when external tax agencies request a tolerance change. Management's complete response to the draft report is included as Appendix V.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions, or your staff may contact Daniel R. Devlin, Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs), at (202) 622-8500.

**Improvements Are Needed in the Automated Underreporter Program to Ensure That
Taxpayer Information Sent to External Tax Agencies Is Accurate**

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Improvements Are Needed in the Automated Underreporter Program to Ensure That Taxpayer Information Sent to External Tax Agencies Is Accurate

Background

The Internal Revenue Service's (IRS) Automated Underreporter (AUR) program matches information reported on individual tax returns against information reported by banks, employers, and other payers. When the AUR matching process identifies a discrepancy, an AUR case is established and an Underreporter Notice (CP2000) is issued to the taxpayer. The CP2000 notice may contain proposed changes to income, payments, credits, and/or deductions. Depending on the taxpayer's response to the CP2000 notice, the AUR caseworker will make necessary tax adjustments to the taxpayer's account.

Tax information can be exchanged with external tax agencies per the Internal Revenue Code¹ and is provided free of charge. These external tax agencies can include state, city, county, and foreign government tax agencies. Currently, AUR case information is provided to 42 state tax agencies and the Puerto Rico tax agency. For Tax Years 1996 through 1999, the IRS has provided external tax agencies with magnetic media tapes containing over 12 million pieces of AUR case information. For Tax Year 1999, this program involved approximately 1.7 million taxpayers with approximately \$1.86 billion in additional federal assessments. External tax agencies may use this information to verify the accuracy of reported state or local income taxes.

The IRS Wage and Investment Division (W&I) and the Small Business/Self-Employed Division (SB/SE) administer the AUR program within six AUR sites. The six AUR sites and the Modernization, Information Technology and Security (MITS) Services compile closed AUR case information onto magnetic media tapes. These tapes are sent to external tax agencies based on need and use requirements of the external tax agencies and stated tolerances.² To provide timely information, the IRS

¹ Internal Revenue Code (I.R.C.) § 6103(d).

² Tolerances are the dollar amount criteria established by external tax agencies, for requesting taxpayer cases. The tolerances are used to exclude lower dollar AUR cases and information from being provided to external tax agencies.

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generally sends six shipments for each tax year under review. At the time of our review, the AUR program had processed five of the six shipments for Tax Year 1999.

When tax information is exchanged, the Office of Governmental Liaison and Disclosure, under the Chief, Communications and Liaison (C&L), provides oversight and education to the IRS and external tax agencies. The Office of Governmental Liaison and Disclosure will enroll the external tax agencies and ensure safeguards are adequate. To receive AUR case information, each external tax agency must enroll in the magnetic media tape exchange program, provide updated safeguard documentation, and be reviewed by the IRS for safeguard measures. We found that the participating external tax agencies generally had the proper documentation in place in order to be enrolled in the program.

This review focused on whether the IRS was minimizing taxpayer burden by providing accurate AUR case information to external tax agencies. We obtained documents from, and held discussions with, employees in the C&L, W&I, SB/SE, and MITS organizations. We conducted our review during July 2001 through July 2002 in accordance with *Government Auditing Standards*. Detailed information on our audit objectives, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

External Tax Agencies Are Provided Inaccurate Automated Underreporter Case Information

The IRS provides external tax agencies with AUR information, and these external tax agencies rely on accurate information for their tax administration. There are two types of AUR cases exchanged, fully agreed and partially agreed. A case is considered fully agreed when the taxpayer agrees with the entire proposed tax change or when the taxpayers' response agrees with part of the proposed tax change and the remaining difference is resolved. A partially agreed case results when the taxpayer agrees with part of the proposed change, as with a fully agreed case, but the taxpayer's recalculation differs from the AUR caseworker's recalculation. If this difference is minimal, the IRS will use the taxpayers' recalculation; otherwise, a revised CP2000 notice is issued.

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For information accuracy, we reviewed statistical random samples of fully agreed and partially agreed AUR cases. These samples were taken from the first two shipments for Tax Year 1999 AUR information being exchanged with external tax agencies. These two shipments had 90,490 fully agreed and 533 partially agreed AUR cases. Only 5 of the 271 (2 percent) fully agreed sample cases we reviewed contained inaccurate data. However, 202 of the 230 (88 percent) partially agreed cases we reviewed contained inaccurate data. We estimate 469 of 533 taxpayers involved with partially agreed AUR cases contained inaccurate data.

Some of the partially agreed error cases we reviewed contained significant differences between the tax increase amounts reported to external tax agencies and the actual tax increases assessed. For example, the IRS reported to an external tax agency that 1 taxpayer owed federal taxes of approximately \$49,000 when the actual amount owed by the taxpayer was approximately \$3,000. In another case, a taxpayer was reported as owing an additional \$6,000 in federal taxes, but the actual assessed amount was a refund to the taxpayer of approximately \$10,000. In the 202 error cases, the IRS inaccurately reported that \$903,937 was owed in federal tax increases when the actual assessed amount totaled only \$108,898. This represents an increase of 730 percent between the tax increases reported to external tax agencies and the actual amounts assessed by the IRS.

Since we selected our samples, 3 more shipments of AUR cases for Tax Year 1999 have been sent to external tax agencies containing 4,625 partially agreed cases. The last shipment for Tax Year 1999 was scheduled for September 2002, and we were not able to analyze it in time to be included in this review.

We found two main causes for the errors. The first cause was that the AUR computer program selected tax information from the most recently issued CP2000 notice rather than the most current data within the case file. This amount can differ because of adjustments made by the AUR caseworker due to a taxpayer's response. An AUR computer programmer said he was unaware of this situation

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and that the program has been this way since the AUR computer program began in 1993. In our sample, 56 (28 percent) of the 202 errors were due to this AUR computer programming.

The second cause of errors was due to AUR caseworkers incorrectly closing cases. AUR caseworkers were not always following Internal Revenue Manual (IRM) procedures when closing partially agreed cases. The errors occurred when the taxpayer and the AUR caseworker agreed to an amount that was different from the initial proposed CP2000 notice amount. In this situation, the IRM procedures require that cases be closed as fully agreed cases, assigned specific processing codes, and recomputed to match the amount to which the taxpayer and AUR caseworker agreed. If cases are not recomputed and assigned the proper processing codes, the system will report the originally proposed amount and not the agreed to amount. In our sample, 146 (72 percent) of the 202 errors were due to AUR caseworkers not following IRM case processing procedures. Managerial reviews conducted by AUR Operations Managers, and Headquarters Quality Reviews conducted by the Program Analysis System have not been effective in disclosing these processing errors in past reviews.

Based on our statistical sample case review, 469 of the 533 partially agreed cases sent to external tax agencies in the first 2 shipments of Tax Year 1999 contained inaccurate AUR case information. Taxpayers involved in this situation may be burdened by having to resolve their tax cases for a second time. This may be simple or complicated and may even require confirmation from the IRS. The IRS could minimize taxpayer burden by providing accurate AUR case information and possibly prevent delays with taxpayers' resolving their tax issues with these external tax agencies.

Recommendations

1. The Commissioner, W&I, the Commissioner, SB/SE, and the Deputy Commissioner for Modernization & Chief Information Officer should coordinate to stop

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sending partially agreed AUR cases to external tax agencies until reliable computer data can be sent.

Management's Response: The Director, Compliance, W&I, coordinated with the other IRS functions to discontinue sending partially agreed AUR cases to external tax agencies.

2. The Commissioner, W&I, the Commissioner, SB/SE, and the Deputy Commissioner for Modernization & Chief Information Officer should coordinate the design and implementation of a computer programming change that selects and sends accurate information when partially agreed AUR cases are involved.

Management's Response: The Director, Compliance, W&I, coordinated with the other IRS functions to amend the AUR computer program for Tax Year 2001 to exchange only fully agreed case information with external tax agencies. The IRS indicated that these changes would not affect the overall volume of cases disbursed to external tax agencies.

3. The Chief, C&L, should alert the external tax agencies of the inaccurate AUR case information being sent by the IRS. He should describe the type of case involved (partially agreed AUR cases) and keep the external tax agencies informed of the IRS' corrective actions until this situation is resolved.

Management's Response: The Deputy Chief, C&L, coordinated the IRS efforts to distribute information explaining the past and future process for exchanging partially and fully agreed AUR cases with external tax agencies. In addition, this information was posted on the Federation of Tax Administrators' web site.

4. The Commissioner, W&I, and the Commissioner, SB/SE, should coordinate to inform and educate the AUR caseworkers about partially agreed case processing and the impact on external tax agencies. Both should also institute quality control measures for AUR casework to ensure that partially agreed cases are processed and closed according to established procedures.

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Management's Response: The Director, Compliance, W&I, coordinated the IRS plans to emphasize the IRM procedures and guidelines through Continuing Professional Education and procedure alerts. In addition, during Fiscal Year 2003 operational reviews will include reviews of partially agreed AUR cases.

Information about the IRS exchange program must be adequately described to external tax agencies in order for these external tax agencies to effectively administer their tax laws. One of the documents necessary to receive computer data extracts from the IRS is the Magnetic Media Extract Program Enrollment Agreement. This enrollment agreement provides information about the external tax agency requesting the information as well as details about the external tax agency's participation in various computer data extract programs, including AUR case information.

Within the AUR case information area, the enrollment agreement must indicate a dollar tolerance to be used to exclude AUR case information that is not useful to the external tax agency. The enrollment agreement contains a line item titled "tolerance to AGI" in which the external tax agency must stipulate a dollar amount that is used to determine the dollar criteria of cases sent to the external tax agency. For example, an external tax agency can set its tolerance at \$500. Any case with a change below \$500 would not be sent to the external tax agency, and cases at or above the \$500 would be sent.

The enrollment agreement does not adequately disclose how the tolerance is applied to AUR case information and leaves the potential for misinterpretation by the external tax agencies. The enrollment agreement indicates that the tolerance is applied to the Adjusted Gross Income (AGI) amount (line 33 of Individual Income Tax Form 1040). We asked external tax agencies about their understanding of how the tolerance is applied. One external tax agency thought the tolerance was applied to the change in AGI amount. A second external tax agency thought it was applied to the change in taxable income amount (line 39 of Form 1040) and a third external tax agency thought it was the total AGI amount.

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From discussions with AUR computer programmers, we determined that the tolerance was actually applied to the change in taxable income amount and not the AGI amount or the total AGI amount. We were told the current AUR programming was inherited from the previous Underreporter program and no changes have been made concerning how the tolerance is applied. There is not a “change to AGI amount” field in the current extract program, so the program uses the “change to taxable income amount field.”

Another document provided to the external tax agencies also did not accurately reflect the tolerance criteria. The CP2000 Extract Specification Book, provided to the external tax agencies annually, contains the file and record structure of the computer data extract for AUR case information but did not clearly explain how the tolerance was applied. This document stated the tolerance field is “the amount to be used for a participating state for a tolerance check” and refers to “increases to Federal Adjusted Income.” Again, the tolerance was actually applied to the change in taxable income amount.

The CP2000 Extract Specification Book and the Magnetic Media Extract Program Enrollment Agreement used by the external tax agency did not reflect how the tolerance was actually applied to AUR case information. The C&L Division was not aware of the incorrect tolerance definitions.

The effect of the incorrect and inconsistent explanation of the tolerance could cause some taxpayers to be unnecessarily included in external tax agency programs, while other taxpayers are excluded. External tax agencies are affected because they are uncertain about the usage and application of the tolerance. External tax agencies could further be affected because the number of cases, on which their revenue assessments are made, fluctuates based on how the tolerance is applied, and their resources may not be effectively used.

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Recommendation

5. The Chief, C&L, should revise future versions of the Magnetic Media Extract Program Enrollment Agreement and the CP2000 Extract Specification Book to clarify the tolerance criteria for AUR cases. In addition, an outreach effort by the Chief, C&L, should be made to each external tax agency to communicate the correct tolerance criteria to ensure a clear understanding of the tolerance application.

Management's Response: The Deputy Chief, C&L, coordinated with the IRS and corrected the wording for the tolerance selection in the CP2000 TY 2000 Extract Specification Book and the Governmental Liaison Data Exchange Enrollment Form. In addition, the IRS revised and distributed the specification book to external tax agencies and posted a notice concerning the revision to the Federation of Tax Administrators' web site.

Procedures Were Not Always Followed When Changes to Tolerances Were Requested

Annually, local Governmental Liaisons and local Disclosure Officers within the C&L Division obtain and review the Magnetic Media Extract Program Enrollment Agreements from participating external tax agencies. This review includes confirmation of the programs in which the external tax agencies want to participate during the coming year, confirmation of the dollar tolerance specified by the external tax agency, and a comparison to the prior year to determine if the tolerance changed. Based on information in the enrollment agreements, C&L prepares a Request for Information Services (RIS) that is used to inform MITS on how to maintain the AUR exchange program. The procedures for preparing a RIS are outlined in the IRS' IRM.

The Detroit Computing Center (DCC) within MITS receives copies of the enrollment agreements from C&L. In the past, personnel at the DCC have prepared a spreadsheet summarizing the enrollment agreements. This spreadsheet summarizes information from the enrollment agreements including the exchange programs the external tax agencies want to participate in as well as the AUR tolerance established by each external tax agency. The spreadsheet is

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sent to the programmers at the Western Development Center (WDC) within MITS, along with the RIS prepared by C&L. The WDC programmers will input necessary changes to the AUR computer program to extract the information. The extracted AUR information is sent to the DCC to separate and forward to the appropriate external tax agency.

During Tax Year 1999, 4 of the 43 participating external tax agencies indicated on their enrollment agreements a request to change their prior years' tolerances. C&L prepared a RIS that was sent, with the enrollment agreements, to the DCC. The RIS did not specifically outline the four changes requested by the external tax agencies. However, the RIS specifically instructed computer programmers to verify tolerances and to make changes as appropriate.

A DCC manager stated that they did not forward the RIS to the WDC because they were new to the process and were unfamiliar with the procedures for processing the RIS. The DCC manager also stated that the WDC programmers acknowledged receipt of the spreadsheet summarizing the enrollment agreements. The DCC assumed the changes would be made, but a WDC programmer stated that changes are made to the AUR computer program only when requested through a RIS. It was confirmed that a RIS had not been received by the WDC for Tax Year 1999 to change AUR tolerances. As a result, tolerance changes requested by the four external tax agencies were not made by the WDC programmers.

Incorrect tolerances in the AUR computer data extracts program cause external tax agencies to receive more or fewer AUR cases than they have requested. In the four instances of Tax Year 1999 tolerance changes that were not made, the requested tolerance was lower than that for the prior year. This means these four external tax agencies should have possibly received more cases than they did. We were unable to determine how many cases these external tax agencies should have received because the data were not available.

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Recommendation

6. The Chief, C&L, and the Deputy Commissioner for Modernization & Chief Information Officer should coordinate to establish and communicate new written procedures that will ensure external tax agencies' requests for tolerance changes via the Magnetic Media Extract Program Enrollment Agreements are properly identified, controlled, and processed. For the AUR computer program, C&L should clearly list each external tax agency with its requested tolerance on an annual RIS. This RIS should be sent to the DCC and WDC. A summarized spreadsheet should not be used in place of the RIS for changes to the AUR computer program.

Management's Response: The Deputy Chief, C&L, and the Director, Business Systems Development, established procedures and responsibility for tolerance changes. The WDC application development team will assume the duties of the RIS. The Director, Business System Development, will provide the C&L office with the name of a contact to facilitate the coordination with any external tax agency that may have changed tolerance levels since the last enrollment. Any such changes will be included in the RIS.

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Appendix I

Detailed Objectives, Scope, and Methodology

The overall objectives of this review were to determine if the Internal Revenue Service (IRS) is protecting taxpayer rights and providing accurate information when disclosing Automated Underreporter (AUR) case information to external tax agencies. To achieve these objectives, the following tests were performed:

- I. Determined if there were concerns, issues, or problems with the exchange of AUR information by contacting various disclosure officers, government liaisons, computer programmers, and external tax agencies.
- II. Determined if AUR case information disclosed to external tax agencies by the IRS is accurate.
 - A. Confirmed the schedule of when AUR case information is exchanged.
 - B. Obtained and validated the first two shipments of computer data extracts for Tax Year 1999. Validated the extracts for content and timing. Clarified data fields with the IRS.
 - C. Obtained the third, fourth, and fifth Tax Year 1999 extract shipments, which occurred in October 2001, January 2002, and May 2002 and determined the numbers and types of AUR cases exchanged.
 - D. Selected two statistically valid random samples from the April and July 2001 computer data extracts of AUR information exchanged with external tax agencies for Tax Year 1999. The sample cases were researched using source documents including taxpayer tax account transcripts, taxpayer returns ordered from the storage files, and AUR case files maintained by the local AUR sites. Exceptions were confirmed with IRS personnel.

The first sample involved exchanged cases marked as fully agreed. Initially we selected a sample of 300 fully agreed cases using the discovery sampling technique (population of 90,490 fully agreed cases, 95 percent confidence level, and estimated error rate not to exceed 1 percent). This sample was converted to the attribute sampling method when errors were identified. In addition, source documents could be obtained for only 271 of the 300 initially selected cases. This sample was reevaluated and found to be statistically acceptable (population 90,490 cases, 95 percent confidence level, error rate of 2 percent from actual case review, and precision of plus or minus 1.61 percent).

The second sample involved exchanged cases marked as partially agreed. Initially we selected a sample of 230 partially agreed cases using the discovery sampling technique (population of 533 partially agreed cases, 95 percent confidence level, and estimated

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error rate not to exceed 1 percent). This sample was also converted to the attribute sampling method when errors were identified. Adequate source documents were obtained for all 230 of the initially selected cases. This sample was reevaluated and found to be statistically acceptable (population 533 cases, 95 percent confidence level, error rate of 88 percent from actual case review, and precision of plus or minus 3.19 percent).

- E. From Modernization, Information Technology and Security Services records, determined the numbers of AUR records exchanged with external tax agencies that have occurred over the past 3 years to date.
- F. From AUR statistical reports, determined the numbers, types, and dollar amounts of AUR closures that have occurred over the past 3 years to date.
- G. Estimated the number of taxpayers affected by unreliable AUR case information by comparing historical AUR information with our case reviews.
- H. Confirmed with IRS management the actual and estimated number of unreliable AUR records sent to external tax agencies and discussed causes and recommendations.
- I. Contacted all six AUR site Operations Managers and discussed the Quality and Management Review process.

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Appendix II

Major Contributors to This Report

Daniel R. Devlin, Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs)

Mary V. Baker, Director

Aaron R. Foote, Audit Manager

Jeff K. Jones, Senior Auditor

Yasmin B. Ryan, Auditor

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Appendix III

Report Distribution List

Deputy Commissioner N:DC
Chief, Communications and Liaison CL
Commissioner, Small Business/Self-Employed Division S
Commissioner, Wage and Investment Division W
Deputy Commissioner for Modernization & Chief Information Officer M
Chief, Information Technology Services M:I
Deputy Chief, Communications and Liaison CL
Director, Business Systems Development M:I:B
Director, Compliance, Small Business/Self-Employed Division S:C
Director, Compliance, Wage and Investment Division W:CP
Director, Office of Governmental Liaison and Disclosure CL:GLD
Chief Counsel CC
National Taxpayer Advocate TA
Director, Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O
Office of Management Controls N:CFO:F:M
Audit Liaisons:
 Chief, Communications and Liaison CL
 Commissioner, Small Business/Self-Employed Division S
 Commissioner, Wage and Investment Division W
 Deputy Commissioner of Modernization & Chief Information Officer M
 National Taxpayer Advocate TA
 Director, Legislative Affairs CL:LA

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Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to the Congress.

Type and Value of Outcome Measure:

- Taxpayer Burden – Potential; 469 taxpayer accounts with inaccurate Automated Underreporter (AUR) case information sent by the Internal Revenue Service (IRS) to external tax agencies during the first 2 shipments of Tax Year 1999 AUR case information (see page 2).

Methodology Used to Measure the Reported Benefit:

We selected two statistically valid random samples from the April and July 2001 computer data extracts of AUR information exchanged with external tax agencies for Tax Year 1999. The sample cases were researched using source documents including taxpayer tax account transcripts, taxpayer returns ordered from the storage files, and AUR case files maintained by the local AUR sites. Exceptions were confirmed with IRS personnel.

1. The first sample involved exchanged AUR cases marked as fully agreed. It was determined from our review of this sample that no corrective action could be recommended to improve our identified error rate of 2 percent; therefore, this type of case will not be considered in calculating the above outcome measure.
2. The second sample involved exchanged cases marked as partially agreed. Initially we selected a sample of 230 partially agreed cases using the discovery sampling technique (population of 533 partially agreed cases, 95 percent confidence level, and estimated error rate not to exceed 1 percent). This sample was converted to the attribute sampling method when errors were identified. Adequate source documents were obtained for all 230 of the initially selected cases. This sample was reevaluated and found to be statistically acceptable (population 533 cases, 95 percent confidence level, error rate of 88 percent from actual case review, and precision of plus or minus 3.19 percent). We made recommendations to improve this error rate of 88 percent; therefore, this type of case was used in calculating the above outcome measure. Using this statistically valid sample, we estimate 469 inaccurate partially agreed AUR cases were sent to external tax agencies during the first 2 shipments of Tax Year 1999.

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Appendix V

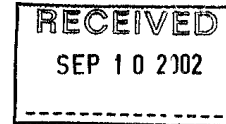
Management's Response to the Draft Report



CHIEF COMMUNICATIONS
AND LIAISON

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

September 9, 2002



MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: David R. Williams *DRW*
Chief, Communications and Liaison

SUBJECT: Draft Audit Report – Improvements Are Needed In The
Automated Under-reporter Program To Ensure That
Taxpayer Information Sent To External Tax Agencies Is
Accurate (Audit #200110043)

As I reviewed your draft report, I was pleased you found that participating external tax agencies had the proper documentation in place to enroll in the IRS Governmental Liaison (GL) Data Exchange Program. The GL Data Exchange Program is vital to the participating agencies in generating additional income. Ensuring that the information we pass on to those agencies is accurate is equally important.

I agree with your recommendation that IRS stop shipping partially agreed case notices, Automated Under-reporter (AUR), to external tax agencies until both IRS and the taxpayer agree on the information. This action could reduce taxpayer burden and eliminate the need for agencies to contact the IRS to seek updated information after a taxpayer contacts them. Wage & Investment and Small Business/Self-Employed have determined that the volume of notices received from the IRS and sent to the participating agencies will not decline – only be delayed until the IRS and the taxpayers agree on the information. By enacting these new programming procedures, participating agencies should not contact taxpayers with invalid assessments.

I have attached a detailed response outlining the corrective actions that Communications & Liaison (C&L), Wage & Investment (W&I), Small Business/Self Employed (SB/SE), and Modernization Information Technology & Service Systems (MITS) will take to address your recommendations. I believe your recommendations and subsequent changes will benefit the IRS and the participating agencies by providing better customer service and more accurate data.

If you have any questions, please contact Clare Calaby, Director, Office of Governmental Liaison, at (202) 622-5155.

Attachment

Improvements Are Needed in the Automated Underreporter Program to Ensure That Taxpayer Information Sent to External Tax Agencies Is Accurate

Attachment

RECOMMENDATION 1

The Commissioner, W&I, the Commissioner, SB/SE, and the Deputy Commissioner for Modernization/Chief Information Officer should coordinate to stop sending partially agreed AUR cases to external tax agencies until reliable computer data can be sent.

ASSESSMENT OF CAUSE

Some partially agreed cases, sent to external tax agencies in the first two shipments of Tax Year (TY) 1999, contained inaccurate AUR case information. This AUR computer program selected tax information from the most recently issued CP2000 notices rather than the most current data within the case file. This amount can differ because of adjustments the AUR caseworker made due to a taxpayer's response.

CORRECTIVE ACTIONS

The Director Compliance, W&I, coordinated with the Director, Compliance SB/SE and the Director, Business Systems Development. IRS will discontinue partially agreed notices in the extract for the remaining distributions for TY 2000.

IMPLEMENTATION DATE

Proposed Completion Date: October 1, 2002

RESPONSIBLE OFFICIAL

Director, Compliance, Wage & Investment

CORRECTIVE ACTION MONITORING PLAN

W&I will review these issues during all AUR operational reviews.

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2

RECOMMENDATION 2

The Commissioner, W&I, the Commissioner, SB/SE, and the Deputy Commissioner for Modernization/Chief Information Officer should coordinate the design and implementation of a computer programming change that selects and sends accurate information when partially agreed AUR cases are involved.

ASSESSMENT OF CAUSE

Some partially agreed cases, sent to external tax agencies in the first two shipments of TY 1999, contained inaccurate AUR case information. The AUR computer program selected tax information from the most recently issued CP2000 notices, rather than the most current data within the case file. This amount can differ because of adjustments the AUR caseworker has made due to a taxpayer's response.

CORRECTIVE ACTIONS

The Director, Compliance, W&I, coordinated with the Director, Compliance, SB/SE, and the Director, Business Systems Development, and the AUR Request for Information Services (RIS) for TY 2001 has been amended to capture only fully agreed case information that will be shared in the extract sent to the participating agencies.

These changes will not affect the overall volume of cases disbursed to the states/cities because all prior partially agreed cases will now show up on the extract when they become fully agreed.

IMPLEMENTATION DATE

Proposed Completion Date: October 1, 2002

RESPONSIBLE OFFICIAL

Director, Compliance, Wage & Investment

CORRECTIVE ACTION MONITORING PLAN

W&I will review these issues during all AUR operational reviews.

Improvements Are Needed in the Automated Underreporter Program to Ensure That Taxpayer Information Sent to External Tax Agencies Is Accurate

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RECOMMENDATION 3

The Chief, C&L should alert the external tax agencies of the inaccurate AUR case information being sent by the IRS. They should describe the type of case involved (partially agreed AUR cases) and keep the external tax agencies informed of the IRS's corrective actions until this situation is resolved.

ASSESSMENT OF CAUSE

Although the Office of Governmental Liaison regularly distributes information about the CP2000 extract via e-mail to all the Governmental Liaisons (GLs), we recognize that we should forward additional information describing the differences between partially agreed and fully agreed cases. We would obtain this information from W&I AUR.

CORRECTIVE ACTIONS

C&L requested and received information from W&I AUR explaining how they handled partially and fully agreed cases in the past and how the AUR program will handle them in the future. They sent this information to all GLs for distribution to the participating agencies and posted a notice on the Federation of Tax Administrators' ListServ in July 2002.

C&L included the following key information in those messages:

- Changes to the AUR program
- W&I's decision not to include partially agreed notices in the extract
- Effective date of this change
- Impact on participating agencies

W&I information indicated that these changes will not affect the overall volume of cases disbursed to the states/cities because all prior partially agreed cases will now show up on the extract when they become fully agreed.

IMPLEMENTATION DATE

Completed: July 29, 2002

RESPONSIBLE OFFICIAL

Deputy Chief, Communications & Liaison

CORRECTIVE ACTION MONITORING PLAN

The C&L office will continue to provide updates to the Governmental Liaisons and participating agencies on the AUR program as received from W&I.

Improvements Are Needed in the Automated Underreporter Program to Ensure That Taxpayer Information Sent to External Tax Agencies Is Accurate

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RECOMMENDATION 4

The Commissioner, W&I and the Commissioner, SB/SE should coordinate to inform and educate the AUR caseworkers about partially agreed case processing and the impact to external tax agencies. Both should also institute quality control measures of AUR casework to ensure that partially agreed cases are processed and closed according to established procedures.

ASSESSMENT OF CAUSE

AUR caseworkers did not always follow Internal Revenue Manual procedures when closing partially agreed cases. Managerial reviews conducted by the AUR Operation Managers, and Headquarters Quality Review were not effective in disclosing these errors.

CORRECTIVE ACTIONS

AUR Headquarters will re-emphasize the IRM procedures and guidelines to each of the AUR operation managers and tax examiners through Continuing Professional Education and procedure alerts. During the third quarter, proper procedures were discussed during a production call with Headquarters staff and Operation Managers. Training during the first quarter of FY 2003 will include emphasis on Internal Revenue Manual procedures for partially agreed cases. Headquarter alerts to the sites will begin in September and continue monthly through the first quarter. Headquarters will notify the AUR sites that FY 2003 operational reviews will include reviews of cases involving this issue.

IMPLEMENTATION DATE

Proposed Completion Date: April 1, 2003

RESPONSIBLE OFFICIAL

Director, Compliance, Wage & Investment

CORRECTIVE ACTION MONITORING PLAN

W&I will review this issue during AUR operational reviews. W&I will include reviews of cases involving this issue during AUR operational reviews.

Improvements Are Needed in the Automated Underreporter Program to Ensure That Taxpayer Information Sent to External Tax Agencies Is Accurate

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RECOMMENDATION 5

The Chief, C&L should revise future versions of the Magnetic Media Extract Program Enrollment Agreement and the CP2000 Extract Specification Book to clarify the tolerance criteria for AUR cases. In addition, an outreach effort by the Chief, C&L should be made to each external tax agency to communicate the correct tolerance criteria to ensure a clear understanding of the tolerance application.

ASSESSMENT OF CAUSE

The GL Data Exchange Program had incorrectly identified the tolerance criteria for AUR cases in both the enrollment form and the specification book. Previously the enrollment form stated "tolerance to AGI." The CP2000 specification book for TY 1999 also identified the tolerance the same way.

CORRECTIVE ACTIONS

When approached by TIGTA in March 2002, concerning the incorrect tolerance criteria, C&L contacted W&I to determine the correct wording for the tolerance selection. When W&I provided the correct language as "tolerance to total taxable income," the C&L office immediately corrected the CP2000 TY 2000 Extract Specification Book. We distributed the revised specification book in April 2002 identifying the changed sections of the book. We accomplished our outreach effort by sending the revised specification book to all GLs for distribution to the participating agencies and posting a notice to the Federation of Tax Administrators (FTA) ListServ alerting them of the revision.

We revised the Governmental Liaison Data Exchange Enrollment Form in August 2002 for the new enrollment period to reflect the correct tolerance information.

IMPLEMENTATION DATE

Completed Date: August 16, 2002

RESPONSIBLE OFFICIAL

Deputy Chief, Communications & Liaison

CORRECTIVE ACTION MONITORING PLAN

The C&L office will continue to work closely with W&I to ensure the enrollment form and specification book information are accurate before distributing to the participating agencies.

Improvements Are Needed in the Automated Underreporter Program to Ensure That Taxpayer Information Sent to External Tax Agencies Is Accurate

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RECOMMENDATION 6

The Chief, C&L and the Deputy Commissioner for Modernization/Chief Information Officer should coordinate to establish and communicate new written procedures that will ensure external tax agencies requests for tolerance changes via the Magnetic Media Extract Program Enrollment Agreements are properly identified, controlled, and processed. For the AUR computer program, C&L should clearly list each external tax agency with their requested tolerance on an annual RIS. This RIS should be sent to DCC and WDC. A summarized spreadsheet should not be used in place of the RIS for changes to the AUR computer program.

ASSESSMENT OF CAUSE

The C&L standard operating procedure was to attach the enrollment spreadsheet to the RIS. This was sufficient in the past to ensure MITS made the appropriate changes. Because of recent changes in personnel and procedures in MITS, they did not make the changes for TY 1999. In addition, we distributed inaccurate information about the tolerance criteria to these agencies

CORRECTIVE ACTION

C&L will coordinate the preparation of a Request for Information Services (RIS) with MITS. MITS has determined that the Western Development Center (WDC) application development team will assume the duties of the RIS supplier/analyst as defined in draft IRM 2.22.1. As the supplier/analyst, the WDC team will coordinate the customer requirements for the CP2000 extract with all other MITS organizations. They will also evaluate the requested work as defined in the RIS and coordinate an implementation schedule with the appropriate customer areas. MITS will provide the C&L office with the name of a contact to facilitate the coordination with any agencies that may have changed tolerance levels since the last enrollment. Any such changes will be included in the RIS. For TY 1999, we updated the tolerance amounts for the four states identified.

IMPLEMENTATION DATE

Deputy Chief, Communications & Liaison: Completed: July 31, 2002
Director, Business Systems Development: Completed: August 1, 2002

RESPONSIBLE OFFICIALS

Deputy Chief, Communications & Liaison
Director, Business Systems Development

CORRECTIVE ACTION MONITORING PLAN

The C&L office will coordinate with MITS when developing a new RIS and ensure all tolerance changes are captured by MITS by listing them in the RIS. MITS will continually monitor the RIS process once received and take the necessary steps to inform all participants named in the extract and distribute copies as needed.